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China's opening up of the banking system

Implications for domestic banks

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As several of the Asian economies have recovered from the East Asian financial crisis, several lessons have become clear. First, the proximate cause of the financial problems in many countries was a futile attempt to defend an overvalued currency. A second more fundamental cause was allowing a weak banking system to become overexposed to foreign exchange risk. However, the recovery of some but not all economies points to a deeper concern. The countries that had stronger financial institutions and undertook more rapid restructuring of their banking systems coped more successfully with the financial crisis. The clear lesson for China is the importance of strong financial institutions when opening up capital markets.

With the accession of China to the WTO, the main question is whether this event can be the impetus to institution building in the banking sector. Currently China is one of the most monetised economies in the world. At the end of 1999, the loan to GDP ratio was 114 per cent. However, four large state-owned banks that have combined market shares in loans and deposits of over 70 per cent dominate the banking sector. Furthermore, interest rates are set centrally by the government and banks have little leeway in pricing risk. Although a program is in place to remove the stock of old bad debt from these four banks' balance sheets by transferring it to asset management companies, the likelihood of the state retaining ownership of these banks for the foreseeable future is high.

The medium-term solution requires China to develop strong financial institutions that will not be unduly hurt by foreign competition and to develop an interbank market to facilitate the liberalisation of interest rates. The requirements for WTO entry are that foreign banks be allowed to conduct all types of foreign exchange transactions with foreign clients immediately on entry and with Chinese clients within one year of entry in designated cities. The Chinese government has

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promised to add four cities to the list each year after accession. Foreign banks must be allowed to make corporate loans in local currency within two years of entry and deal with individual Chinese customers five years after entry. Furthermore, foreign banks are allowed to engage in joint ventures and full foreign ownership will be permitted within five years of entry. How to navigate in these potentially turbulent waters is the crucial concern for Chinese policymakers today. The natural tendency is to fear cream-skimming by stronger, more financially savvy foreign banks, leaving weak domestic banks still weaker. In this chapter, we consider the impact of foreign entry in Chinese banking based on the experiences of the Central European fast-track transition economies and taking account of the current situation in China and the prospects for reform. We conclude by taking a tentative glimpse into the future that should allay the worst fears of the Chinese authorities.

Literature and experiences from Central Europe

The literature on foreign bank entry in developing countries indicates that it may be a two-edged sword.¹ Although foreign penetration should enhance the efficiency of the domestic banking sector and hence be welfare-improving, it also puts competitive pressure on weak domestic banks. Early literature concludes that foreign banks have traditionally followed abroad their customers who have already established a position in the host country through FDI. However, more recent literature indicates that foreign banks are being more aggressive and entering domestic markets to acquire business and take market share from domestic banks (Seth *et al.* 1998).

The effects of foreign bank entry in eighty countries, both industrialised and developing, over the period 1988–95 are studied by Claessens *et al.* (1998). These authors find that, while domestic banks do lose market share and become less profitable due to competition, the overall welfare effect on the domestic economy is positive. Goldberg *et al.* (1999) find evidence in Argentina and Mexico that foreign entry increased the stability of the domestic banking sectors as loan growth increased, while the volatility of this growth decreased. Regarding the transition economies, Buch (1997) argues that allowing foreign bank entry improves the production of financial services, promotes competition, facilitates bank privatisation, and transfers know-how and technology to the host countries. Her only caveat is that the domestic banks be fully recapitalised for truly inherited bad loans prior to opening up the banking sector to foreign competition. Since conditions in the banking sectors of the transition economies resemble the situation in China today, we take a more detailed look at foreign entry in the Central European fast-track countries.

The experiences of these countries indicate that foreign banks find it much

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easier to acquire market share in credit markets than in deposit markets. By mid 1999 in Poland, foreign banks accounted for 10 per cent of all banking offices, 22 per cent of the deposit market, 33 per cent of all net loans and 35 per cent of the banking capital. Included in these aggregates are several Polish banks that were privatised to strategic foreign investors in addition to the greenfield operations of foreign entrants. At the end of 1998 in the Czech Republic, foreign banks accounted for 22 per cent of total credits and 15 per cent of total deposits. Two of the five largest banks in the Czech Republic had been privatised to strategic foreign investors at this time. At the end of 1998 in Hungary, foreign banks held 63 per cent of all banking assets, 67 per cent of registered capital, 76 per cent of total corporate credits but only 36 per cent of household deposits (Buch 2000). Foreign banks' market shares in Hungary are a result both of the privatisation of all major commercial banks to strategic foreign owners and of the early entry of greenfield foreign branches. The only major bank in Hungary that is owned domestically is the former state savings bank OTP, the shares of which are widely held by domestic and foreign portfolio investors. OTP currently holds 40 per cent of all retail deposits. The bank with the second largest market share in retail deposits, Postabank, is currently in state receivership.

The largest foreign bank, ABN-Amro, was created when a large domestic commercial bank, Magyar Hitel Bank, was privatised in a sale to the Dutch bank that subsequently merged the purchase with its own greenfield operation. ABN-Amro, with more than 104 branches, has recently claimed that it holds 10–15 per cent of the retail deposit market (BCE 2000:34). Another Dutch bank, ING, recently sold its unprofitable twelve-branch retail banking operation to Citibank although it had only moved into retail banking in 1997 (BCE 2000:34). Clearly, even in a small country like Hungary, success in retail banking depends on an extensive branch system. Estimates for Central Europe place the cost of building a new branch at US\$400,000 (BCE 2000:36). Clearly, domestic banks have a comparative advantage in the old bricks and mortar branch system that collects household deposits. This legacy explains the relatively strong market position maintained by domestic banks in retail banking.

Data on interest spreads indicate that the achievement of a threshold level of foreign ownership of banking assets may be necessary before competitive pricing pressure is felt by domestic banks. Interest rate spreads in Poland and the Czech Republic have been relatively constant from 1995 to 1999 whereas, in Hungary the spread has declined by almost 50 per cent since 1997 (Buch 2000: graph 2). By the end of 1997, the major commercial banks in Hungary had been privatised to strategic foreign investors and foreign banks' share of the corporate credit market exceeded 70 per cent. In Poland and the Czech Republic, this same share was under 20 per cent at the end of 1997. This evidence is consistent with the hypothesis that foreign banks create a more competitive market environment but only when

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their aggregate market share reaches a critical threshold.

Interestingly, data on classified credits indicate that the mere presence of active foreign banks may have a positive influence on combating soft lending. In Poland and Hungary, the share of classified credits decreased from a peak of around 30 per cent in 1993 to below 10 per cent in 1998 (Buch 2000: graph 1). In the Czech Republic, the share of classified credits has remained high at around 30 per cent reflecting to some extent the restrictive entry practices regarding greenfield foreign operations. However, the passive attitude toward commercial banking taken by the foreign owner of the largest privatised bank, IPB, also contributed to a soft lending environment. IPB bank was taken over by the Czech National Bank after a scandal regarding the tunneling of assets from the bank's investment funds by the foreign owner, the Japanese investment bank, Nomura. This evidence is consistent with the hypothesis that a credible threat of competition from foreign banks disciplines domestic banks and leads to an improvement in the quality of their portfolios so long as the soft lending environment is not tacitly approved.

What are the lessons for China from the experiences of Central European countries regarding foreign entry in the banking sector? Overall, foreign banks' market shares were not large in these countries until these banks became significantly involved in the privatisation of domestic banks. This point is seen from a comparison of Hungary with the other two countries at the end of 1998. Recently, foreign ownership of Polish banks has increased dramatically through privatisation and the large Czech banks are in the process of being privatised by strategic foreign owners. For countries with small, open economies that are aspiring to join the European Union, such an outcome is expected.

However, even when strategic foreign investors acquire existing banks in Central Europe, foreign banks' market shares in the deposit markets are significantly smaller than in the credit markets. Hence, there is room for domestic banks that have a comparative advantage in retail activity in these countries. Most importantly, the experiences of the Central European countries demonstrate that competitive pressure from foreign entry evolves only gradually and depends on the foreign banks' share of credit markets becoming significantly large. Therefore, domestic banks have a window of opportunity to adjust to competition. In a large, relatively closed economy such as China, the adjustment period is likely to be even longer as the competitive pressure will evolve even more gradually and be managed by the authorities. Furthermore, the eventual outcome need not involve market dominance of the banking sector by foreign banks as the situation in many large countries with open capital markets demonstrates.

Foreign bank penetration in China: the current situation

There are already a large number of foreign financial institutions present in China,

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although the extent and breadth of their business are still relatively restricted. Under the current regulatory framework, the Commercial Bank Law is also applicable to foreign banks in China. However, the establishment and operation of foreign financial institutions are set out mainly in the Regulations of the People's Republic of China on Foreign Financial Institutions. According to this Regulation, a foreign commercial bank may engage in some of the foreign exchange businesses, including deposit-taking, lending, brokerage and settlement, but mainly for foreign-funded enterprises.²

In December 1996, the PBC promulgated the Provisional Regulations on the Experimental Renminbi Business by Foreign Financial Institutions in Pudong. Qualified foreign banks in the Pudong District of Shanghai started to conduct local currency business on a trial basis. Currently, foreign financial institutions are allowed to receive RMB deposits from foreign-funded enterprises, foreigners who have lived in China for at least one year, or re-deposits of their RMB loans to non-foreign-funded enterprises only. At the same time, they are allowed to extend RMB loans and provide guarantee services to foreign-funded enterprises or non-foreign-funded enterprises that have received their foreign currency loans or guarantees only. The experiment was later extended to include Shenzhen.

At the end of 1999, thirteen foreign banks had been set up wholly owned (six) or joint venture operations (seven) in China (for a complete list of foreign banks in China at the end of 1998, see Appendix 5.1).³ In addition, foreign banks were operating 157 branches in the country. The minimum requirement for a foreign bank to set up a wholly owned or joint venture bank was total assets of US\$10 billion. The same requirement for opening a branch was assets of US\$20 billion. The total assets of foreign banks in China amounted to 262.9 billion RMB (US\$31.8 billion) or about 2 per cent of the total bank assets in 1999. Loans by foreign banks were 180.5 billion RMB (US\$21.8 billion) and deposits were 43 billion RMB (US\$5.2 billion). Regarding local currency affairs, the foreign banks made loans of 6.7 billion RMB or about 3.7 per cent of their total, and held deposits equal to 5.44 billion RMB or about 12.7 per cent of their total assets.

The data indicate that penetration of Chinese banking by foreign banks to the beginning of the twentieth century had been insubstantial. Loans to total assets was about 69 per cent while the ratio of local currency loans to assets was a mere 0.25 per cent. Deposits to total assets were only 16.4 per cent while the ratio of local currency deposits to assets less than 0.25 per cent. Clearly, foreign banks restricted their activity in China mostly to servicing their own clients and almost exclusively to dealing in foreign currency. The Chinese authorities restricted the ability of foreign banks to engage in local currency business.

The major restriction on foreign banking activities was a locational one. Wholly owned and joint venture banks in addition to foreign branch banks were permitted to set up operations only in cities designated by China's State Council. Foreign

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financial institutions located only in Shanghai or Shenzhen were allowed to apply for the right to conduct business in the local currency. Thirty-two foreign banks—of which twenty-four were in Shanghai and eight in Shenzhen—were engaged in renminbi affairs. In 1999, about one half of total foreign banking assets, loans and deposits were held by banks in Shanghai. In March 2000, the central bank announced that foreign banks with two or more branches in the country must designate one branch as its main reporting entity to strengthen the PBC's control over foreign banks. Many large banks, for instance Citibank and HSBC, designated their Shanghai branch as the main branch. These policies seem designed to promote Shanghai as an important financial centre in Asia.

A commentary in the April 2000 edition of *Shanghai Jinrong* (available online at <URL:<http://ChinaOnline.com>> on 9 May 2000) recommended that China adopt a gradual approach to foreign banking to allow the domestic banking sector sufficient time to improve its efficiency and to prevent it from being further weakened by foreign competition. In the first stage, protection, foreign banks are allowed to follow their clients into the country and promote FDI. Significant restrictions on location and the scope of business are imposed during this period. According to the article, China is moving from this stage to the transition period or second stage. In this phase, restrictions are eased and foreign exchange business is completely open. Furthermore some banks are allowed to conduct local currency business and foreign banks are allowed to operate in a larger number of coastal and inland cities. During this stage it is imperative that domestic banks restructure and become more competitive in anticipation of moving to the final stage: maturity. According to the article, foreign banks must be 'managed' during this period to prevent them from bringing overseas financial risks to China and to guide them to support Chinese policies and development strategies.

In June 2000, the president of the China Construction Bank, Wang Xuebing, warned that China must adopt a law that regulated competition between foreign and domestic banks. Mr Wang warned of a worst-case scenario in which domestic banks keep only the unprofitable banking business and foreign banks skim the cream of the profitable business. How far and how quickly the Chinese authorities are prepared to move in the transition period is unclear. To what extent the management of foreign banks referred to above involves the maintenance of restrictions rather than arm's-length supervision will be a crucial determinant of the depth of foreign bank penetration in China. Hence the benefits of foreign entry will depend on the regulatory policies pursued by the Chinese authorities.

In April of the same year, the president of the Bank of China, Liu Mingkang, supported the use of the capital market to reform banks in three stages (see <URL:<http://ChinaOnline.com>> on 19 April 2000). In the short term, China will focus on developing the interbank capital market and the government bond market. In the medium term, interest rates are to be liberalised. Mr Liu

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recommended relaxing the upper limit on commercial bank lending first to avoid malignant competition between banks through the efforts of banking associations. Once reform has proceeded, the government can relax the minimum loan interest rates. In the longer term, banks will look to the capital market for funds by issuing shares and mergers between state-owned banks while large international banks can be arranged by stock swaps. Interestingly, this plan does not envision a role for a strategic foreign investor in privatising the four large state-owned banks but rather imagines the outcome to be a merger of equals. For this vision to be realised, Chinese banks must be strengthened institutionally.

The introduction of a market-based interest rate is also on the agenda. Earlier, the PBC liberalised the interbank market interest rate. The next step is to liberalise the lending rate, although commercial banks are already allowed to adjust the lending rate by plus or minus 10 per cent, and plus 30 per cent for loans to small enterprises. The deposit rate, however, is likely to remain highly regulated for an extended period.

On 10 May 2000, the Chinese Association of Banks (CAB) was formed in Beijing as a non-profit self-regulating organisation with a mission of formulating professional conventions and self-regulating standards (see <URL:<http://ChinaOnline.com>> on 12 May 2000). Jiang Jianqing, the current president of the Industrial and Commercial Bank of China, was appointed as the head of the CAB. Hence, the institution is already in place to manage the competition on interest rates referred to by Mr Liu. Allowing banks to charge higher rates to commercial clients will permit them to better price the risk of loans but it is likely that the cartel nature of CAB will blunt competition and promote cooperation. This may be a useful in constraining interest rates and may actually encourage the sharing of financial information on clients that is necessary for banks to price risk appropriately. However, when the limit is removed from deposit rates, the CAB is likely to discourage significant competitive reductions in interest rates. Without competition on deposit rates, the banks will retain the benefits of liberalisation through their rent monopoly, rather than sharing them with households as they would if deposit rates were determined competitively.

What is at stake?

Approximately half of China's population of 1.2 billion have bank accounts. The loan to GDP ratio at the end of last year was 114 per cent, one of the highest in the world. The big four domestic banks have a combined market share of about 70 per cent (Table 5.1).

Together, these four major banks have extensive branch networks across the country, with nearly 125,000 branches and 1.6 million employees. However, their financial performance is unsatisfactory. The profitability of these banks has fallen

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Table 5.1 **China's financial system, end of 1997 (RMB billion)**

Financial institutions	Number of branches	Number of employees	Total deposits	Household deposits	Total assets	Total loans
PBC	2,416	188,000	..	..	..	..
NDB	-	1,000	..	..	..	24.00
CADB	2,000	110,000	..	..	66.46	62.50
CEIB	-	500	..	..	1.85	1.42
ICBC	31,400	520,000	179.75	113.13	..	163.30
ABC	55,640	490,000	89.50	61.70	..	77.13
BOC	1,795	195,754	48.64	31.07	..	47.50
CBC	35,895	356,864	103.00	50.90	..	74.57
12 other banks	700	45,211	49.77	6.61	..	33.66
RCCs	50,219	563,000	87.90	..	..	63.64
UCCs	4,243	90,980	29.70	..	..	19.52
TICs	244	32,400	61.82	..	27.34	32.23
FCs	67	..	13.22	..	8.18	6.35
SEC	94	..	..	..	15.90	..

Notes: The three policy banks are the National Development Bank (NDB), the China Agricultural Development Bank (CADB) and the China Export-Import Bank (CEIB). The four major banks include the Industry and Commerce Bank (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC) and the Construction Bank of China (CBC). RCCs and UCCs refer to rural and urban credit cooperatives, respectively (UCCs have been transformed into urban commercial banks in some cities). TICs are trust and investment corporations, FCs are finance companies and SEC are stock exchange centres. The 12 other banks referred to are shareholding commercial banks such as CITIC Industry Bank, China Everbright Bank and Minsheng Bank.

Source: People's Bank of China.

consistently since the beginning of the 1990s. Most would have made losses in the mid 1990s if uncollected interest payments had been excluded from the revenues on their income statements (Bonin and Huang 2000). Of the total profits generated by these major banks in recent years, about 95 per cent came from almost half a dozen coastal cities, such as Shenzhen, Guangzhou, Xiamen, Shanghai, Beijing and Tianjin (Yi 2000). Unfortunately, these cities will become the centre of the battlefield when foreign banks compete aggressively for domestic clients. If Chinese banks lose significant market share in these cities, the more dire forecasts of the harmful effects of foreign entry will be realised.

Retail banking is a growth industry in China. Housing loans account for less than 1.5 per cent of all loans made (see <URL:http://ChinaOnline.com> on 28 March 2000). In a survey of 3,900 people from Beijing, Tianjin, Shanghai, Guangzhou, Wuhan and Harbin, conducted by the Social Survey Institute of China (SSIC), 71 per cent ranked buying a house as a top goal (see <URL:http://ChinaOnline.com> on 4 April 2000). An average house costs at least eight times a family's annual income and a downpayment of RMB 100,000 to qualify for a loan. Taken together, this information indicates the significant growth potential of the housing loan market and provides a major reason for the high saving rate in

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China. Whether or not significant competition from foreign banks should be expected in this market is unclear. On the one hand, housing loans transactions tend to be concentrated in banks with local knowledge and household clients so that domestic banks have a comparative advantage in this area. On the other hand, collateral on housing loans may be more transparent and secure than collateral on small business loans so that foreign banks in some Central European countries have taken an interest in this market.

Xiong Anping, president of Visa (China), claims that credit card usage is still in its infancy in China and that foreign banks will focus on these rather than the existing debit cards issued by Chinese banks (see <URL:<http://ChinaOnline.com>> on 26 July 2000). In a survey of 1,678 people from Beijing, Shanghai, Nanjing, Guangzhou, Wuhan and Changsha, conducted by the SSIC, more than 40 per cent have at least one plastic bank card but many didn't bother to use them because of the difficulty in doing so (see <URL:<http://ChinaOnline.com>> on 2 June 2000). Although major Chinese banks have issued plastic cards, they are not interchangeable and thus not widely accepted because merchants find it impossible to have separate machines for each card. Furthermore these are mostly debit cards. ICBC issues the Peony Card that has a thirty-day overdraft facility but is essentially a debit card. Foreign banks could overcome the interchangeability problem by issuing the Visa cards.

The Bank of China has issued about 200 million debit cards on which the annual transaction volume is RMB 2.42 trillion. Bankcards are beginning to be used as a secondary medium of exchange in China. In Hungary, a country in which the ratio of banking assets to GDP is only 70 per cent, 3 million people or about 35 per cent of the population have credit or debit cards and use them about once a month on average (BCE 2000:36). As with much of Central Europe, China is likely to skip the stage of instituting checks and move directly to plastic money as a co-medium of exchange with cash. Consequently, bankcards and ATMs are likely to be important vehicles for acquiring market share in retail banking in China. In Hungary, the domestic bank OTP is the market leader in ATMs because of its branch network and competes aggressively in the bankcard market. With their extensive branch networks, Chinese domestic banks are well positioned to capture a reasonable share of this new retail business.

According to Zhu Min, the general manager of the BOC's Institute of International Finance, online banking is the direction in which the Chinese banking sector should be expanding (see <URL:<http://ChinaDaily.com>> on 30 July 2000). Internet use has grown by an average of 80 per cent over the last five years in China, compared with 50 per cent in the rest of Asia. China's commercial banks have launched several online products and the demand has created some technical problems. Octasoft Co. Ltd has offered its business-to-business e-financial solutions—which have been successful in other Asian banks—to Chinese financial

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institutions to assist in their online banking endeavours. According to Mr Zhu, Chinese banks risk losing out to non-banking institutions in providing certain banking services due to the rapid penetration of the Internet. Given the high cost of building new branches, several foreign-owned banks in Poland are developing e-banking operations. However, there are only 20,000 customers online in Poland (BCE 2000:36). Nonetheless, foreign banks are likely to become an important source of competition in e-banking for China's large banks.

China's response

In order for the domestic financial sector to survive the international competition brought about by WTO membership, the Chinese authorities must step up their efforts to strengthen the domestic banks. In the wake of the East Asian financial crisis, China introduced a number of reform measures to improve the health of the banking sector, mainly through the introduction of better banking practices and a program to deal with the stock of bad loans in the four large banks. In 1998, the Ministry of Finance issued RMB 270 billion of special treasury bonds for the recapitalisation of the four major banks, raising their average capital-adequacy ratio from 4.4 per cent to the 8 per cent required by the Commercial Bank Law.

Another important policy measure was the creation of asset management companies (AMCs) to deal with the bad loans (Bonin and Huang 2000). About RMB 1,300 billion of non-performing loans (NPLs), which is about 19 per cent of the total outstanding loans, are scheduled to be transferred from the banks to the AMCs. By the end of 1999, a total of RMB 350 billion had been transferred, including those resulting in debt-equity swaps. The AMCs are charged with working out the bad loans and using capital markets for asset sales. Since capital markets are still primitive in China and the direction of ownership reform for the large state-owned enterprises is still not clear, the sale of these debts will be a difficult undertaking. Recovery rates on problem assets have not been high in Central Europe. In a Polish program, the recovery rate for a limited number of small loans was less than 25 per cent of face value. In May 2000, the Chinese government made a policy decision to allow AMCs to sell non-performing assets and shares taken in debt-equity swaps to foreign companies. Although this is an important policy change, substantial transactions have not been taken place so far.

While both recapitalisation of the banks and the creation of AMCs for the resolution of bad loans are important steps in improving the health of the domestic banking sector, a more important issue is to stop the creation of new NPLs that lead to a continued deterioration of asset quality. In August 2000, only one and a half years after the first round of recapitalisation to achieve regulatory standards, the central bank called on the four major banks to boost their average capital-adequacy ratio from 6 per cent to above 8 per cent (*Asian Wall Street Journal*, 4

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August 2000). This suggests that the quality of the banks' financial assets continued to deteriorate after 1998. In this environment, it is difficult for the authorities to make a credible commitment to a once-off transfer of NPLs to the AMCs.

Loss-making SOEs continue to exist. For example, in the first half of 2001, total losses made by SOEs were RMB 46 billion, which is more than one-half of total SOE profit. Moreover, the state continues to intervene in lending decisions. From 1998–99, the Ministry of Finance spent RMB 200 billion on infrastructure projects in order to achieve the government's growth target. Commercial banks were called on to provide RMB 400 billion in policy loans for companion projects. To prepare the domestic banks for international competition requires a significant improvement in the behaviour of bank lending. SOE reform is a necessary first step. Bank managers' incentives were improved gradually as they were given more responsibility in exchange for more accountability. In mid 2000, the central bank stressed its earlier instruction to the banks to stop lending to loss-making SOEs. Hence, the completion of reforms of both the state sector and the state budget is an important precondition for successful bank restructuring.

Financial supervision of the banks has also gradually strengthened. At the end of 1998, the government introduced international accounting standards to banks, although the nationwide application of this system is still incomplete. On 21 March 2000, the State Council published a new set of regulations for the supervision of state-owned financial institutions (see <URL:<http://ChinaOnline.com>> on 23 March 2000). The document states that supervision committees will be sent to state-owned banks to oversee their financial and accounting activities. Included among the mandates of the supervision committees is the evaluation of the chief executives and the responsibility to submit proposals for rewards and punishments including appointments and removals. These committees will inspect the procedures for capital management and oversee the financial affairs of the banks. This document indicates that the State Council through these supervision committees is taking an active role in monitoring and regulating state-owned banks.

The Bank of China (BOC) signed an agreement on 6 June 2000 with Reuters to use the Kondor+ Risk Management System for its financial operations (see <URL:<http://ChinaOnline.com>> on 9 June 2000). The system will be customised for the BOC in China and was initially installed in the Beijing and Hong Kong offices. This is the first time that a large Chinese bank has used a third-party vendor to solve IT problems rather than depend on in-house development. Kondor+ is an applications system for risk management that is designed to handle e-commerce, credit and risk management.

The Industrial and Commercial Bank of China (ICBC), the largest of the four state-owned banks, has introduced a centralised system of credit management to monitor and supervise its 400,000 clients (see <URL:<http://ChinaDaily.com>>

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on 30 July 2000). This system replaces the situation in which local branches were responsible for all loans. As part of this restructuring, ICBC introduced procedural management techniques into its credit department. This reorganisation is designed to solve the problem of soft lending by local branches. During the first six months of 2001, ICBC's lending activity increased by RMB 165.6 billion, which was RMB 71.4 billion more than in the same period in 2000. This increase in activity was coupled with an improvement in the quality of new loans as only 0.66 per cent of these were non-performing, which, according to its president Jiang Jianqing, is the lowest amount in ICBC's history. Consumer loans constituted 21.8 per cent of all new loans, an increase of 6 percentage points from the same period in 2000, indicating that ICBC is becoming more aggressive in retail banking.

Taken together, these observations indicate a willingness on the part of both the regulatory authorities and the major domestic banks to change banking practice in China prior to any serious market penetration through the entry of foreign banks. In a related area, China is also accelerating reforms of the stockmarkets. The China Securities Regulatory Commission (CSRC) is contemplating a number of proposals, including

- opening up the A-share market to foreign companies (or their joint ventures) and, most probably, creating a Taiwan-style QFII system while the capital account is still closed
- merging the Shanghai and Shenzhen stockmarkets (to Shanghai) and setting up a secondary board for growth enterprises (likely to be in Shenzhen)
- and combining A and B shares, and possibly even including H shares.

A key issue left largely untouched to date is the ownership of the large domestic banks. Will it be necessary to privatise these four state-owned banks in some way to improve the efficiency and competitiveness of the banking sector? At the moment, the government appears to favour industry consolidation and internal restructuring rather than seeking strategic foreign investors. However, the smaller state-owned banks are being listed on the stockmarket gradually and sequentially.⁴ As the stockmarket deepens and broadens, the possibility of selling small packages of shares in the four major banks arises. Following a policy similar to the one undertaken by the Hungarian government in privatising OTP, the Chinese authorities could gradually privatise these large banks over a reasonable period of time to domestic and foreign portfolio investors. Under this scenario, the four large state-owned banks could be privatised yet remain domestic Chinese banks.

A glimpse into the future

On which edge of the sword is China likely to find itself over the next decade because of its entry into the WTO? Will foreign bank penetration be deep enough

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to enhance the efficiency of Chinese banking and the welfare of China's economy? Will China's big four state-owned domestic banks lose significant market share under this competitive pressure and become vulnerable to foreign takeover? These are important issues for policymakers in China to address during the five-year transition period afforded by the phase-in provision of removing restrictions in the WTO agreement. By combining our analysis of the experiences of the Central European transition economies with foreign bank entry and our consideration of the current situation in Chinese banking, we conclude with some conjectures on these issues.

Will foreign banks be a stimulus to institution building in China's financial sector? Our answer is yes. Competition will obviously spur domestic banks to develop products and services in order to retain good clients. Less obvious perhaps is the role that foreign banks are likely to play in stimulating the development of the interbank market. The four large state-owned banks in combination with the network of rural and urban cooperative banks are sure to collect more than 95 per cent of all household deposits. From experiences in other countries, foreign banks are not likely to be interested in building bricks and mortar branch networks to collect household deposits in the traditional way. Currently, the foreign banks operating in China make loans in excess of 400 per cent of the deposits that they collect in the country. Clearly, they are using external sources of financing. However, as their business in China grows, foreign banks will look increasingly to domestic sources of funds. Hence, foreign banks will have an incentive to push for the development of an interbank market of which they will be a significant part of the demand side. Under the supervision of China's central bank, the interbank market can be an important ingredient in the liberalisation of interest rates, the pricing of risk and the development of monetary policy.

Will foreign banks be a stabilising factor in the financial sector by facilitating capital outflows and setting up conditions in China for an East Asian-type financial crisis? Interestingly enough, our answer is no. Although an open capital account can lead to ebbs and flows of speculative short-term capital, foreign banks are likely to be a buffer. Because foreign banks actually have a stake in the financial stability of the host country and because they are subject to domestic banking supervision, they are more likely to be a stabilising influence. The traditional concern that foreign banks would respond to economic conditions in their home country and thus be a conduit of financial problems seems to be overshadowed now by concerns about transmission mechanisms in international capital markets. Foreign direct investment in the banking sector is no different from FDI in other sectors in that it constitutes a long-term commitment to the host country. Foreign banks should not be feared as a destabilising factor. On the contrary, they are likely to have a stabilising influence on short-term speculative capital movements.

Are foreign banks likely to compete with domestic banks for profitable corporate

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clients and wealthy retail clients? Based on experiences in other countries and the likely development of Chinese banking, the answer must surely be yes. Is this cream-skimming avoidable? At least in the longer term it is probably unavoidable. High-profile profitable business clients will have alternatives to the domestic banking sector for raising funds. As the financial sector liberalises, these companies will be able to access domestic and international capital markets for both equity and debt. Once the capital account is open, wealthy retail clients will also have full access to international investment opportunities. The question becomes one of whether it is better to lose this business and these clients to foreign banks operating within a domestic regulatory system or to international capital markets.

Recent government policies and the practices of foreign banks indicate that Shanghai is the financial capital of China and could become an important financial hub in Asia. That Shanghai is one of six coastal cities that provide the vast majority of profitable business for China's major banks, makes the competitiveness of the big four domestic banks in this hub and the other cities crucial. To facilitate the maintenance and development of business in these profitable areas, the government must allow the domestic banks to reallocate resources from non-profitable activities. To the extent that the big four banks are beholden to local governments in their branch network, they can not allocate their resources properly and will be at a competitive disadvantage with respect to foreign banks. To the extent that the big four banks are persuaded by the federal government to support designated projects that are complementary to the government's economic policy, domestic banks will have a competitive disadvantage with respect to foreign banks. Hence, independent bank governance is a necessary condition for the big four banks to compete effectively with foreign entrants. Therefore, a credible commitment to only arm's-length regulation by the government and a gradual divestiture of the state's ownership shares to domestic and foreign portfolio investors should have high priority on the policy agenda in China.

Since retail banking is a growth industry in China, the battle for retail clients will be fierce. Domestic banks have the inside track on housing mortgages due to their established client relationships. However, this informational advantage can be squandered if these banks are not allowed to compete aggressively on pricing and the terms of the contract with foreign banks. Because housing loans afford transparent and relatively secure collateral, foreign banks are attracted to this business. Hence, domestic banks must be allowed to offer mortgages on competitive terms.

Plastic money will be an area of intense competition between foreign and domestic banks. Although the big four have begun to issue debit cards, the infrastructure for easy use is not in place. Because foreign banks issue bankcards that are accepted worldwide, they have a comparative advantage in developing cards that would be accepted universally in China. However, the big four banks have the branch networks in place to provide a complementary product, such as

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cash machines. By offering a bankcard that can be used both as a debit card and at ATMs, the big four banks can take advantage of their branches by providing clients with both means of exchange. The pre-requisite for domestic banks to compete effectively is the development of information technology (IT) systems to handle such transactions.

The immediate development of IT capabilities is crucial if the big four hope to compete in the nascent, small, but developing area of internet banking. Foreign banks will find e-banking particularly attractive as an alternative to building brick-and-mortar branches to attract retail clients. Even though e-banking is only currently available to a very small number of people in China, it is an area in which foreign banks could engage in significant cream-skimming. Furthermore, as China's capital market develops, the ability to cross-sell investment products to wealthy retail clients has significant profit potential. The big four domestic banks need to develop an integrated IT strategy that takes account of their comparative advantage in branch banking but does not disregard the future evolution of internet banking.

Is the sword of foreign entry likely to pierce the heart of the big four banks in China? The answer depends on how the government and the banks use the window of opportunity provided by the phase-in period. The more quickly the government removes restrictions from the credit and deposit markets, the more likely it is that domestic banks will learn how to price risk appropriately, leading to a significant improvement in the quality of their assets. The more the banks become independent from direct government control, from their inherited portfolios of policy loans and from their implicit obligations to weak clients, the more likely it is that they will be strong enough to compete with foreign banks. The more quickly the government allows capital markets to develop, the more options become available to facilitate the independent governance of the big four domestic banks. Hence, supported by appropriate policy reforms, the big four Chinese banks are capable of taking a firm stand on the battleground created by China's accession to the WTO.

Appendix 5.1

Foreign financial institutions in China (as of 31 December 1998)

- 1 Wholly-owned foreign banks (6)
 - Concord Bank (Ningbo)
 - Xiamen Commercial Bank (Xiamen)
 - Ningbo International Bank (Ningbo)
 - TM International Bank (Shanghai)
 - Nantong Bank Ltd (Zhuhai)
 - Rabobank China Ltd (Shanghai)

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- 2 Sino-foreign joint venture banks (7)
 - First Sino Bank (Shanghai)
 - The International Bank of Paris & Shanghai (Shanghai)
 - Chinese Mercantile Bank (Shenzhen)
 - Zhejiang Commercial Bank (Ningbo)
 - Xiamen International Bank (Xiamen)
 - Qingdao International Bank (Qingdao)
 - Fujian Asia Bank Ltd (Fuzhou)
- 3 Foreign bank branches (69 banks with 153 branches from 16 countries)
 - Australia (1 bank with 2 branches)
 - ANZ Banking Group Ltd (Shanghai, Beijing)
 - Belgium (2 banks with 3 branches)
 - Credit Bank NV (Shanghai)
 - Generale Bank (Guangzhou)
 - Britain (1 bank with 8 branches)
 - Standard Chartered Bank PLC (Shanghai, Shenzhen, Xiamen, Tianjin, Zhuhai, Haikou, Nanjing)
 - Canada (3 banks with 5 branches)
 - Royal Bank of Canada (Shanghai)
 - Bank of Nova Scotia (Guangzhou, Chongqing)
 - Bank of Montreal (Guangzhou, Beijing)
 - France (6 banks with 17 branches)
 - Societe Generale (Shanghai, Shenzhen, Guangzhou, Tianjin, Wuhan)
 - Credit Lyonnais (Shanghai, Xiamen, Tianjin)
 - Credit Agricole Indosuez (Shanghai, Guangzhou, Shenzhen)
 - Banque Nationale de Paris (Shenzhen, Tianjin, Guangzhou, Beijing)
 - Banque de Paris et des Pays-Bas (Shanghai)
 - Germany (5 banks with 8 branches)
 - Dresdner Bank AG (Shanghai, Shenzhen, Beijing)
 - Commerzbank AG (Shanghai)
 - Deutsche Bank AG (Guangzhou)
 - Westdeutsche Landesbank (Shanghai)
 - Bayerische Landesbank (Shanghai)
 - Hong Kong (13 banks with 34 branches)
 - The Bank of East Asia Ltd (Shanghai, Shenzhen, Xiamen, Guangzhou, Dalian, Zhuhai)
 - Nanyang Commercial Bank Ltd (Shenzhen, Guangzhou, Dalian, Haikou, Shekou, Beijing)
 - Hongkong and Shanghai Banking Corporation Ltd (Shanghai, Shenzhen, Xiamen, Tianjin, Qingdao, Beijing, Dalian, Wuhan)
 - Po Sang Bank Ltd (Shanghai, Shenzhen, Qingdao)

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- Dao Heng Bank Limited (Shenzhen)
- Chiyu Banking Corporation Ltd (Xiamen, Fuzhou)
- Wing Hang Bank Ltd (Shenzhen)
- Hua Chiao Commercial Bank Ltd (Shantou)
- Liu Chong Hing Bank Ltd (Shantou)
- Heng Sheng Bank Ltd (Guangzhou, Shanghai)
- Asia Commercial Bank Ltd (Shenzhen)
- Xin Hua Bank Ltd (Shenzhen)
- Kuangtung Provincial Bank (Shenzhen)
- Italy (2 banks with 2 branches)
 - Banca Commerciale Italiana (Shanghai)
 - Banco di Roma SPA (Shanghai)
- Japan (12 banks with 30 branches)
 - Bank of Tokyo-Mitsubishi Ltd (Shanghai, Shenzhen, Dalian, Beijing)
 - Sanwa Bank Ltd (Shanghai, Beijing, Shenzhen, Dalian)
 - Sumitomo Bank Ltd (Shanghai, Guangzhou, Yangpu, Shuzhou)
 - Sakura Bank Ltd (Shanghai, Guangzhou, Tianjin)
 - Industrial Bank of Japan Ltd (Shanghai, Dalian, Beijing)
 - Fuji Bank Ltd (Shenzhen, Dalian, Shanghai)
 - Dai-ichi Kangyo Bank Ltd (Shanghai, Dalian)
 - Yamaguchi Bank Ltd (Qingdao, Dalian)
 - Tokai Bank Ltd (Tianjin, Shanghai)
 - Daiwa Bank Ltd (Shanghai)
 - Asahi Bank Ltd (Shanghai)
 - Long-Term Credit Bank of Japan Ltd (Shanghai)
- Korea (7 banks with 9 branches)
 - Korea Exchange Bank (Tianjin, Dalian, Beijing)
 - Hanil Bank (Shanghai)
 - Shinhan Bank (Tianjin)
 - Korea Development Bank (Shanghai)
 - Commercial Bank of Korea (Shanghai)
 - Industrial Bank of Korea (Tianjin)
 - Cho Hung Bank (Tianjin)
- Netherlands (2 banks with 6 branches)
 - ING Bank NV (Shanghai, Shenzhen, Xiamen)
 - ABN-Amro Bank (Shanghai, Shenzhen)
- Portugal (1 bank with 1 branch)
 - Banco Nacional Ultramarino SA (Zhuhai)
- Singapore (4 banks with 9 branches)
 - Overseas Chinese Banking Corporation (Shanghai, Xiamen, Tianjin, Chengdu)

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United Overseas Bank Ltd (Xiamen, Guangzhou)
Overseas Union Bank Ltd (Shenzhen)
Development Bank of Singapore (Shanghai, Beijing)
Switzerland (1 bank with 1 branch)
Credit Suisse (Shanghai)
Thailand (3 banks with 5 branches)
Bangkok Bank Ltd (Shanghai, Shantou, Xiamen)
Krung Thai Bank Ltd (Kunming)
Thai Farmers Bank Public Company Ltd (Shenzhen)
USA (5 banks with 11 branches)
Bank of America (Shanghai, Guangzhou, Beijing)
Citibank, NA (Shanghai, Shenzhen, Beijing, Guangzhou)
Bank of The Orient (Xiamen)
First National Bank of Chicago (Beijing)
Chase Manhattan Bank, NA (Tianjin, Shanghai)

Notes

- 1 This section relies heavily on Buch (2000).
- 2 The 13 areas specified by the Regulation that foreign banks may engage in include: foreign currency deposit-taking, foreign currency lending, foreign currency bill-discounting, approved foreign exchange investments, foreign exchange remittance, foreign exchange guarantee, import and export settlement, foreign currency dealing and brokerage, exchanging of foreign currencies and foreign exchange bills as an agent, foreign currency credit card payment, custodial service, credit verification and consulting, local currency businesses and other foreign exchange businesses approved by the PBC.
- 3 Information in this section is taken from articles on the internet. See <URL:<http://ChinaOnline.com>> for 3 March 2000, 6 March 2000, 9 May 2000 and 16 May 2000.
- 4 Pudong Development Bank and Shenzhen Development Bank are already listed on the domestic stockmarket, while the Bank of Communication and Minsheng Bank are finalising the procedures for listing.